TEACHERS' RETIREMENT BOARD

REGULAR MEETING

SUBJECT: Fiduciary Responsibility Presentation ITEM NUMBER: 9

ATTACHMENT(S): 1

ACTION: ____ DATE OF MEETING: June 7, 2001

INFORMATION: X PRESENTER(S): Ian Lanoff

Periodically, our fiduciary counsel, Ian Lanoff, has made presentations to Board Members concerning their fiduciary responsibilities under the Education Code and California Constitution. Mr. Lanoff, of the Groom Law Group, has served as CalSTRS' fiduciary counsel since 1984. He represents other large public pension plans as well as private and multi-employer Taft-Hartley pension plans in fiduciary law matters. Before entering private practice, Mr. Lanoff was the Administrator of Pension and Welfare Benefit Programs at the U.S. Department of Labor. He previously served as Counsel to the U.S. Senate Committee on Labor and Public Welfare and as General Counsel to the United Mine Workers of America Health and Retirement Funds. He received his B.A. and J.D. degrees from the University of Michigan and his L.L.M. from Georgetown University Law School.

Mr. Lanoff has prepared an updated memorandum to the Board concerning its fiduciary responsibilities, which is an attachment to this item.

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MEMORANDUM

May 29, 2001

TO: CalSTRS Board of Trustees

FROM: Ian D. Lanoff

RE: Fiduciary Responsibilities

The law sets a high standard for the conduct of a fiduciary.[1] In this memorandum, we summarize the fiduciary duties of Board members, officers and employees (collectively, "statutory fiduciaries")[2] of CalSTRS under the California Constitution ("Constitution") and the California Education Code "Code"). The basic fiduciary rules under the Constitution and the Code are derived almost verbatim from the federal Employee Retirement Income Security Act of 1974 ("ERISA"). For this reason, and because there are no regulations and almost no state court cases interpreting the Constitution or the Code, this memorandum relies heavily on regulations and case law under ERISA to interpret the fiduciary rules applicable here. References are also made to the Internal Revenue Code because it is applicable based on the tax-exempt status of CalSTRS. We also discuss the potential liability of statutory fiduciaries for violating these duties.

FIDUCIARY DUTIES

1. The duty to act prudently.

The Constitution and the Code require statutory fiduciaries to discharge their duties:

> with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims.[3]

This means that a statutory fiduciary must act with something more than the simple skill of any reasonable person. Statutory fiduciaries must act with the degree of skill deployed by other trustees for other pension plans or by persons in comparable positions of authority. Prudent decision making requires a careful investigation of the proposed action;[4] it is no defense that a decision was made in good faith.[5]

Recognizing that Board members may not always possess the requisite degree of investment expertise, the legislature has expressed its intent that the Board secure expertise.[6] In addition, the Board is directed to hire "experts" – at least two investment advisors, and an investment advisor for corporate management issues.[7]

Most cases interpreting ERISA's prudence requirement deal with plan investment decisions. It is important to realize, however, that all acts – or failures to act – by statutory fiduciaries are subject to the duty of prudence. For example, one state court has held that the trustees of the state retirement system violated their duty to act prudently by failing to act against the legislature's unlawful failure to appropriate sufficient funds for required contributions to the system.[8]

As a gloss on prudence, the Internal Revenue Service has stated that an investment satisfies the exclusive benefit rule if four conditions are met: (1) the cost does not exceed the fair market value at the time of the purchase; (2) the investment provides a fair return commensurate with the prevailing rate; (3) sufficient liquidity is maintained to permit distributions in accordance with the terms of the plan; and (4) the safeguards and diversity that a prudent investor would adhere to are present.[9]

Also, the U.S. Department of Labor has promulgated a "prudence" regulation under ERISA that provides that the duty is fulfilled if (1) the fiduciary making an investment or engaging in an investment course of action has given appropriate consideration to those facts and circumstances that, given the scope of the fiduciary's investment duties, the fiduciary knows or should know are relevant, and (2) the fiduciary acts accordingly. This includes giving appropriate consideration to the role that the investment or

investment course of action plays (in terms of such factors as diversification, liquidity and risk/return characteristics) within the overall investment portfolio.[10] This approach, a departure from the common law of trusts, permits fiduciaries to make decisions which, while relatively risky, in isolation, are permitted when measured against the riskiness of the whole portfolio.[11]

The Constitution and the Code require statutory fiduciaries to "diversify the investments of the system so as to minimize the risk of loss and to maximize the rate of return, unless under the circumstances it is clearly not prudent to do so."[12] Improper diversification includes investment of an "unreasonably large proportion" of plan assets in a single security; a single type of security; or various types of securities that depend "on the success of one enterprise or upon conditions in one locality."[13]

2. The duty to act "solely in the interest" and for the "exclusive purpose" of serving system members.

Statutory fiduciaries are required by the Constitution and the Code to discharge their duties solely in the interest of system members, retirants, and their beneficiaries, and for the exclusive purposes of (i) providing them with benefits, and (ii) defraying reasonable administrative expenses.[14] That means that these factors exclusively must motivate and guide decisions by a statutory fiduciary. The Internal Revenue Code of 1954, as amended, imposes a similar

requirement that a pension plan must be established and operated for "the exclusive benefit of . . . employees and their beneficiaries" in order to be a qualified plan under section 401(a) of the Internal Revenue Code.

The receipt of "incidental benefits" by a fiduciary, or by a party with an interest in the Board's decision, as a result of a fiduciary decision will not violate the exclusive benefit rule.[15] Making California a better place to live for all Californians may be an "incidental benefit." In fact, any social or non-economic considerations involved in investment decisions are deemed to result in incidental benefits so long as the risk and return characteristics of investment alternatives are equivalent.[16] However, statutory fiduciaries could not simply lend money to help one county in economic difficulty because teachers live there. Nor can statutory fiduciaries simply invest either to foster or to inhibit other social, political or economic goals.[17]

While ERISA rulings and court decisions have held otherwise, in two situations, a court and the IRS have concluded in the governmental plan context that the impact that a proposed investment might have on the fund sponsor that makes contributions is a permissible factor for investment consideration. In those situations, both the United States District Court for the Southern District of New York and the Internal Revenue Service ("IRS") concluded that fiduciaries of a municipal pension fund lawfully could consider

the financial condition of the sponsoring city government before deciding to authorize investments in bonds issued by the city.[18]

The Constitution adds a third "exclusive purpose" requirement applicable to Board members only: to minimize employer contributions to participants and their beneficiaries.[19] The Board's duty to participants and beneficiaries, however, takes precedence over "any other duty."[20]

3. The duty to act in accordance with governing documents.

The Code requires statutory fiduciaries to act in accordance with the documents and instruments governing the system unless those documents and instruments are inconsistent with their other fiduciary duties.[21] It is not clear what "documents and instruments" would be considered to govern the system. On an issue in which plan documents appear to conflict with prudence considerations, it would not be unusual for fiduciaries to seek a declaratory judgment from a court or to obtain expert opinions.[22]

4. The duty not to engage in certain transactions.

The Code prohibits statutory fiduciaries from engaging in three types of transactions: transactions with system members, transactions with an employer, and transactions involving self-dealing.

a. Transactions with members, retirants or beneficiaries of the system.

Statutory fiduciaries may not cause the system to engage in the following transactions with any member, retirant or beneficiary of the system (or of the Cash Balance Benefit Program), unless otherwise provided by law or unless the transaction is at arms-length (i.e., adequate consideration is given or received): (i) buying, selling, or leasing of system property; (ii) furnishing of goods, services or facilities to or from the plan; or (iv) transfer to, use by, or benefit from plan assets.[23]

b. Transactions with an employer.

Statutory fiduciaries may not cause the system to acquire any security, real property, or loan of any employer, as defined in the Code as the state or any agency or political subdivision of the state for which creditable service subject to coverage by the plan is performed.[24] A parallel provision provides that the assets of the System may not inure to the benefit of an employer.[25] In 1998, legislation was enacted which creates a limited exception to this prohibition for credit enhancement for bonds, notes, certificates of participation or other evidences for indebtedness of an employer, as long as the Code and federal Internal Revenue (IRC) Code are complied with.[26] The IRC provision with which the system must comply requires arm's length dealings between the creator of the trust and the trustees.[27]

c. Transactions involving self-dealing.

Statutory fiduciaries may not (i) deal with the system's assets in their own interest; (ii) act on behalf of a party whose interests are adverse to the system's; or (iii) receive any consideration from a party dealing with the system in connection with a transaction involving the system's assets (the "anti-kickback rule").[28]

i. Dealing with the system's assets in one's own interest. A statutory fiduciary will be found to have used the system's assets for his or her own interest if he or she (a) uses the authority or control that makes him or her a fiduciary to cause the system to use assets in such a way that he or she will benefit, and (b) has an interest in the transaction at issue that could affect his or her best judgment as a fiduciary.[29]

This is the provision that should concern elected officials who serve on the Board (or appoint a designee) who may be in a position to hire or retain vendors from whom they have received campaign contributions. This is also the provision that should concern any trustee who receives travel, meal or entertainment benefits from vendors or vendor candidates for hire.[30]

Courts have found that a fiduciary used plan assets for his own interest where the fiduciary invested plan assets in companies in which he owned substantial equity interests,[31] authorized payment for his own services[32] or participated in a decision to pay himself an excessive salary.[33] A statutory

fiduciary may avoid engaging in a prohibited transaction by removing himself or herself from the decisionmaking process and not otherwise exercising fiduciary authority over the decision, unless the fiduciary causes system assets e.g., fees) to be paid to other fiduciaries pursuant to an agreement that the other fiduciaries will reciprocate.[34]

ii. Action on behalf of an adverse party. A statutory fiduciary may not act on behalf of a party whose interests are adverse to the system's, even if he or she receives no personal gain. This is the provision that should concern trustees who consider putting the interests of the state of California, or employers or employees located in California, school districts or other employing agencies, the teachers union, or vendors ahead of the interests of the system. A fiduciary will be found to have violated this provision automatically where the other party that it represents has interests that are antithetical to the system's.[35] Where the other party represented by the fiduciary has interests that may overlap the system's, courts appear to determine whether the fiduciary has acted unlawfully by examining the transaction in the light of the prudence and "solely in the interest" duties; if these duties are met, the fiduciary generally will not be found to have acted on behalf of an adverse party.[36] Thus, it may be permissible for a statutory fiduciary to represent another party in a transaction involving the system, even if the other party receives an incidental benefit from the transaction.[37]

iii. Receiving kickbacks. Statutory fiduciaries may not receive anything of value in their individual capacity from any party dealing with the system in connection with a transaction involving system assets. Although this provision technically prohibits all gifts by entities dealing with the system, the cases finding that a violation has occurred all involve situations where the fiduciary received consideration in the amount of thousands of dollars. It seems reasonable to expect that courts would evaluate a fiduciary's receipt of de minimus gifts by examining the action in the light of the prudence and "solely in the interest" tests, similar to their treatment of potential violations of the rule against acting on behalf of an adverse party.

A fiduciary charged with violating the anti-kickback rule must prove by "clear and convincing evidence" that compensation he or she received was for some service other than a transaction involving plan assets.[38] The fact that the entity giving the "kickback" to the fiduciary received no quid pro quo, or that the fiduciary accepted the gift or other consideration in good faith, does not matter in determining whether a violation has occurred.[39]

LIABILITY FOR FIDUCIARY BREACH

1. Liability for own breach.

A Board member or officer who engages in prohibited transactions is personally liable under the Code to restore losses to the system and to

disgorge any profits obtained through the breach. A court may also order other equitable relief, such as removal from office.[40]

Effective in 1990, statutory fiduciaries generally are exempt from personal liability for failure to fulfill their duties to diversify investments and to act prudently, solely in the interest of participants, and in accordance with plan documents.[41] There are two exceptions to this general exemption of personal liability. First, statutory fiduciaries remain personally liable for gross negligence or fraud in the investment of system assets. Second, statutory fiduciaries remain personally liable for breach of fiduciary duty in connection with the "administration of the plan."[42] The administration of the retirement plan exception presumably requires that fiduciaries act prudently and in accordance with the relevant documents only with respect to decisions whether to pay or not to pay benefits; any broader interpretation of "administration" would threaten to contradict the general rule exempting them from fiduciary liability.

Although the exemptions from liability appear on their face to be quite broad, statutory fiduciaries should remain attentive to their fiduciary decisions. The difference between making investment decisions negligently, which cannot result in liability, and making decisions with gross negligence, which can result in liability, can be difficult to ascertain. In addition, although the statute relieves statutory fiduciaries of liability for failing to satisfy the

"exclusive purpose" and "solely in the interest of" duties, violations of those duties will also in most cases mean that the fiduciary has engaged in an unlawful self-dealing transaction for which the fiduciary can still be held liable. Therefore, statutory fiduciaries can take only limited comfort from the exemptions from liability.

2. Liability for breach of co-fiduciaries.

A statutory fiduciary may be held liable for a breach of a co-fiduciary if he or she (i) knowingly participates in or conceals the breach; (ii) "enabled" the breach through engaging in an unlawful transaction, or (iii) has knowledge of a breach and does not take reasonable steps to remedy it.[43] Courts have held that actual knowledge of a breach is required and that a fiduciary who does not know, but should have known, about a breach by a co-fiduciary, consequently, cannot be held liable for the breach.[44]

3. Liability for breach of contractual fiduciaries.

Statutory fiduciaries are not liable for the actions of investment managers so long as they satisfy the prudence standard in selecting and monitoring investment managers.[45] Thus, once the Board has chosen an investment manager, it must continue to oversee the manager's performance. Under ERISA, the U.S. Department of Labor has advised:

> At reasonable intervals the performance of trustees and other fiduciaries should be reviewed by the appointing fiduciary in

> such manner as may be reasonably expected to ensure that their performance has been in compliance with the terms of the plan and statutory standards, and satisfies the needs of the plan. No single procedure will be appropriate in all cases; the procedure adopted may vary in accordance with the nature of the plan and other facts and circumstances relevant to the choice of the procedure.[46]

Statutory fiduciaries are not shielded from fiduciary liability with respect to the performance of other, non-investment manager contractual fiduciaries. Since it is not clear whether investment managers or these other contractual fiduciaries can be held liable for misconduct under the Code, it is important that CalSTRS contracts with investment managers and other contractual fiduciaries impose liability for misconduct on the contractual fiduciary.

Finally, the Code requires that all statutory fiduciaries who are authorized to invest funds shall be covered by fiduciary insurance in an amount determined by the Board to be prudent.[47]

ENDNOTES

[1] Justice Benjamin Cardozo explained the standard this way:

> [M]any forms of conduct permissible in a work-a-day world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilo of an honor the most sensitive, is then the standard of behavior.

[2] The Code does not identify any parties as fiduciaries; nor does it define the word "fiduciary". However, the Board is granted powers and authorities which would make Board members fiduciaries under the common law of trusts and comparable federal and state legislation. See Cal. Ed. Code §§ 22202, 22203. The Board may also bestow fiduciary status on independent contractors and investment managers under the terms of their contracts with CalSTRS. This memorandum refers to individuals designated as fiduciaries under the terms of a contract with CalSTRS as "contractual fiduciaries."

[3] Cal. Const. Art. XVII, § 17(c); Cal. Educ. Code § 22250(b).

[4] See, e.g., Donovan v. Mazzola, 716 F.2d 1226, 1232 (9th Cir. 1983), cert. denied, 464 U.S. 1040 (1984) (prudence involves an examination whether the trustees "employed the appropriate methods to investigate the merits of the investment and to structure the investment").

[5] See Donovan v. Cunningham, 716 F.2d 1455, 1467 (5th Cir. 1983), cert. denied, 467 U.S. 1251 (1984) ("a pure heart and an empty head are not enough").

[6] Cal Educ. Code §§ 22350, 22351.

[7] Cal Educ. Code §§ 22353, 22354.

[8] Dadisman v. Moore, 384 S.E. 2d 816, 825 (W. Va. 1988).

[9] Revenue Ruling 69-494, 1969-2 C.B. 88. See also Rev. Rul. 73-380, 1973-2 C.B. 124; H.R. 93-1280, 93d Cong., 2d Sess., at 302, reprinted in 3 Legislative History of ERISA 4277, 4569 (April 1976).

[10] 29 C.F.R. § 2550.404a-1.

[11] Id.

[12] Cal. Const. Art. XVIII, § 17(d). The Code's requirement, at Cal. Educ. Code § 22250(c), is nearly identical.

[13] Conference Report on ERISA, H.R. Rep. No. 1280, 93d Cong., 2d Sess. 304 (1974).

[14] Cal. Const. Art. XVII, § 17(b); Cal. Educ. Code §§ 22250(a), 22251(a). The U.S. Supreme Court in NLRB v. Amax Coal Co., 453 U.S. 322 (1981) interpreted identical language to the California language to mean that a fiduciary owes a fund a duty of complete undivided loyalty, to the exclusion of all other interests.

[15] See, e.g., In re Gulf Pension Litig., 764 F. Supp. 1149 (S.D. Tex 1991) (exclusive benefit rule prohibits a fiduciary only from using plan funds solely for its own direct, primary benefit and not from receiving incidental benefits, where the obvious purpose of the action is to benefit participants.)

[16] See Donovan v. Bierwirth, 680 F.2d 267, 271 (2d Cir. 1982), cert. denied, 459 U.S. 1063 (1982) (plan trustees "do not violate their duties as trustees by taking action which, after careful and impartial investigation, they reasonably conclude is best to promote the interests of participants and beneficiaries simply because it incidently benefits the corporation or, indeed, themselves..."). But see Board of Trustees of Employees Retirement Sys. v. Mayor of Baltimore, 562 A.2d 720 (Md. 1989), cert. denied, 493 U.S. 1093 (court, without applying the "incidental benefit" analysis, held that the city's plan may invest in accordance with social considerations if the cost is de minimus).

[17] Proposition 162 amended the Constitution in 1992 to permit legislation prohibiting the Board from making certain investments so long as the prohibition satisfies the Board's fiduciary duties. Cal. Const. Art. VXII, § 17(g). On the other hand, Code provisions authorizing CalSTRS investments in a Home Loan Program, a Home Repair Program and in California Residential Realty specifically recognize that such investments are to be made subject to fiduciary requirements. Cal. Ed. Code §§§ 22360(a); 22361(a); 22362(c) and (d).

[18] See Withers v. Teachers' Retirement System of the City of New York, 447 F.Supp. 1248 (S.D.N.Y.) 1978), aff'd mem., 595 F.2d 1210 (2d Cir. 1979); IRS Letter Ruling addressed to Paul R. Thompson (Oct. 30, 1981) ("Detroit Letter"), reprinted in 371 Pens. Rep. (BNA) J-9 to J-11 (Dec. 7, 2981).

[19] Cal. Const. Art. XVII, § 17(b).

[20] Id. This provision, which was added by Proposition 162, appears to incorporate the holding of a California case that the requirement to minimize contributions may not override the requirement that the fund be administered in the best interest of the participants and beneficiaries. City of Sacramento v. Public Employees Retirement Sys., 229 Cal. App. 3d 1470, 280 Cal. Rptr. 847 (1991).

[21] Cal. Educ. Code § 22250(d).

[22] See Morgan v. Independent Drivers Association Pension Plan, 975 F.2d 1467, 1471 (10th Cir. 1992) (trustees relied on advice of attorney and actuary).

[23] Cal. Educ. Code § 22252(a)-(d).

[24] Cal. Educ. Code §§ 22252(e); 22131.

[25] Cal. Educ. Code § 22251(a).

[26] Cal. Educ. Code § 22260.

[27] IRC § 401(a)(2)(the "exclusive benefit rule") and IRC § 503 (the "prohibited transaction" rules). The latter provision, which is explicitly referred to in Cal. Educ. Code § 22260, will be violated by the system unless the transaction with the employer is accompanied by "adequate security" and a "reasonable rate of interest." In order to avoid the risk of non-compliance with these two somewhat ambiguous requirements, it is advisable to comply with a "safe harbor" contained in IRC § 503(e). The safe harbor basically contains four conditions: all investors receive identical terms; the system does not hold more than 25 percent of any investment; at least 50 percent of the investment is held by investors independent of the employer and the

investment together with other employer related investments does not constitute more than 25 percent of the system's asset portfolio.

[28] Cal. Educ. Code § 22225.53. These prohibitions against self-dealing are grounded in the duty of undivided loyalty; "solely in the interest" / "exclusive purpose" duties and these duties overlap. See, Eaves v. Penn, 587 F.2d 453, 457 (10th Cir. 1978).

[29] See Department of Labor Reg. § 2550.408b-2(f).

[30] In 1998, the legislature added a provision to the Code that requires disclosure of campaign contributions in the amount of $250 or more and of gifts in the amount of $50 or more in the course of a Board vendor selection process. Failure to disclose shall serve as a basis for disqualification. Cal. Educ. Code § 22363.

[31] Lowen v. Tower Asset Management, Inc., 829 F.2d 1209, 1214 (2d Cir. 1987).

[32] Gilliam v. Edwards, 492 F. Supp. 1255, 1263 (D. N.J. 1980).

[33] Weisler v. Metal Polishers Union, 533 F. Supp. 209 (S.D.N.Y. 1982).

[34] DOL Advisory Opinion Letter (May 7, 1992).

[35] See, e.g., Cutaiar v. Marshall, 590 F.2d 523 (3d Cir. 1979) (plan trustees of two plans who negotiated a loan between the plans engaged in an unlawful transaction because the interests of borrowers and lenders are always adverse). There may be an exception to this rule if state law authorizes the fiduciary to act on behalf of the other party. California courts have not addressed this issue, but a New York court has held that the state comptroller, who was also trustee of the state's retirement fund, could lawfully purchase bonds issued by the state on behalf of the fund, where the state laws sanctioned his dual roles. Westchester Chapter, Civil Serv. Employees Ass'n v. Levitt, 337 N.E.2d 748 (N.N. 1975).

[36] See, e.g., Donovan v. Bierworth, supra, 680 F.2d at 270-271 (plan trustees acted on behalf of both the plan and the corporate employer in causing the plan to buy employer stocks will not be found to have acted on behalf of an adverse interest if the transaction, which benefits both the corporation and

the plan, satisfies the prudence and "solely in the interest" tests). Whitfield v. Tomasso, 682 F. Supp. 1287 (E.D.NY 1988) (plan trustees who permitted a union to keep contributions intended for the plan were found to have acted on behalf of an adverse party where the trustees also violated the prudence and "solely in the interest" duties). But see Sandoval v. Simmons, 622 F. Supp. 1174, 1213-14 (C.D. Ill. 1985) (adverse interests mean different, not necessarily antithetical, interests).

[37] Donovan v. Bierworth, supra, 680 F.2d at 270-27.

[38] Lowen v. Tower Asset Management, Inc., supra 829 F.2d at 1215.

[39] Brink v. DaLesio, supra, 496 F. Supp. 1368 (plan trustee who received gratuities from plan's service-provider violated anti-kickback rule regardless of whether the service-provider received any consideration from the plan).

[40] Cal. Educ. Code § 22254(a).

[41] Cal. Educ. Code § 22255.

[42] Id.

[43] Cal. Educ. Code § 22256.

[44] See e.g., Davidson v. Cook, 567 F. Supp. 225, 233 (E.D. Va. 1983); aff'd mem. 734 F. 2d 10 (4th Cir. 1984).

[45] Cal. Educ. Code § 22257(a).

[46] Interpretive Bulletin 29 C.F.R. § 2509.75-8, Q&A FR-17.

[47] Cal. Ed. Code § 22259(b). See also, § 22258.